Big Tobacco Seeks $1.2 Billion Cut In Payments to States

By VANESSA O'CONNELL

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State governments, addicted to billions in revenue from the tobacco industry, have begun to worry that they will have to cut back.

Forty-six states are expecting a total of $6.5 billion this spring, the latest in a series of annual payments stemming from the 1998 Master Settlement Agreement with major tobacco companies. But Altria Group Inc.'s Philip Morris USA and others say they expect to withhold $1.2 billion and are raising the possibility that they will seek similar cuts in years to come.

The 1998 agreement -- which requires big tobacco companies to pay $206 billion into state treasuries -- has been seen as a success by the states. At a news conference today in Washington, D.C., state attorneys general plan to release figures showing that U.S. cigarette consumption has dropped to a 55-year low. They credit the settlement, which, among other things, imposed sharp curbs on cigarette marketing.

For budget-stretched state governments, the agreement has provided a windfall. So far, the tobacco companies have paid states $41.1 billion, with each year's payments based roughly on cigarette sales volume the previous year.

But the pact has also proved subject to interpretation. In the current dispute, Philip Morris, R. J. Reynolds Tobacco Co. and other major companies are citing an "adjustment" provision that allows them to cut their payments, after a two-year waiting period, if their collective market share drops below certain thresholds.

In 2003, the companies say, they hit such a threshold: The companies' collective share of the market dropped eight percentage points, from 99.6% in 1997 -- the year before the settlement -- to about 92% in 2003.

The companies inserted the adjustment provision into the agreement out of concern that they would lose market share to smaller upstart cigarette makers that would come into the market. The big companies have argued that, because smaller rivals -- such as S&M Brands, Inc., which makes Bailey's Cigarettes -- aren't subject to the marketing limits and cost burdens of the settlement, the small players can sell cigarettes at lower prices.

The states, in turn, argue that they have taken the steps required in the settlement to create a level playing field; they say they've enacted and enforced laws requiring the companies outside the settlement to set aside similar payments in escrow accounts. (Unlike the big companies' payments, the escrow money is refundable, but only after 25 years. Some of the smaller companies are suing the states over these laws.)

The provision also stipulates that the big tobacco companies must show that their market-share loss is significantly attributable to the burdens of the agreement and that the states didn't try hard enough to level the playing field.

The states have vowed to fight for the full payments. But they've already been hit with one setback: An independent arbiter's preliminary ruling, rendered March 1, found that the burdens of the settlement agreement were a significant factor in the market-share loss.

States have until March 13 to submit comments and arguments to the arbiter, the Brattle Group, whose final decision is due March 27. Meanwhile, the states aren't taking chances. Massachusetts, California and others have begun notifying the tobacco companies, as required under the settlement agreement, that they could sue the companies for the full payments. The states will argue that they have diligently enforced the settlement throughout the years.

"This is a long way from being final," said Tom Dresslar, spokesman for California Attorney General Bill Lockyer. California, which expected about $826.8 million in payments this year, could get roughly $158 million less.

A loss of revenues could be bad news for many states that have come to count on the billions flowing from the tobacco companies. The money has helped finance health-care programs, education and public works, and increasingly, general operating expenses. Many states have floated bonds secured by the payments. For fear that the money could stop, some states have passed laws to protect the cigarette companies from bankruptcy if they lose tobacco lawsuits.

"It's important money -- and it's perpetual money -- and at this point, it is part of states' ongoing budgets," says Joy Johnson Wilson, director of the health committee at the National Conference of State Legislatures in Washington. "A major reduction that's not planned for would require some juggling."

Some observers think this fight could actually lead to a stronger agreement by making the two sides renegotiate. "Overall, we're not convinced that the major manufacturers will succeed in getting the $1 billion...but this battle could lead to another settlement [and] an ironclad partnership between the states and tobacco manufacturers," Bonnie Herzog, a tobacco analyst for Citigroup, said in a March 6 report.

The feud could resonate in the bond markets too. At least ten cash-strapped states and many cities and counties have issued almost $32 billion in bonds that are explicitly backed by the future flow of settlement money, according to Fitch Ratings. If the bonds are viewed as riskier, the states would be forced to pay higher interest rates.

Moody's Investors Service rates most tobacco securitizations as low investment-grade bonds "under review with direction uncertain." Moody's declined to comment on whether the latest dispute might trigger a downgrade.

The tobacco companies are optimistic. "We fully expect the final determination will be the same as the preliminary determination," Phillip Morris assistant general counsel Robert Buell said in a March 2 letter to PricewaterhouseCoopers. He wrote that Philip Morris "made an overpayment" for 2003 and thus is entitled to a dollar-for-dollar offset for what it overpaid, plus interest, totaling $1.1 billion. Thomas McKim, deputy general counsel at Reynolds, sent a similar letter.

Antitobacco health groups are skeptical. "The evidence is strong that the states have gone to great lengths to live up to their obligations under the master settlement agreement," said Matt Myers, president of the Campaign for Tobacco Free Kids, an antitobacco advocacy group.

Write to Vanessa O'Connell at vanessa.oconnell@wsj.com1